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SUBJECT: Subic Freeport Fuel and Vehicle Smuggling

SENSITIVE BUT UNCLASSIFIED

Summary

1. (SBU) Lack of political will and weak law enforcement has allowed wide-spread smuggling of refined petroleum products and second-hand vehicles through the Subic Freeport, seriously hurting legitimate businesses. The Government is also losing badly-needed revenues (equivalent to between 4%-5% of tax collections and at least 0.6% of Gross Domestic product during 2006). We are exploring ways to assist the American Chamber of Commerce and U.S. companies to advocate for a determined anti-corruption campaign targeting smuggling. End Summary.

Car Manufacturers Up Against Used-Vehicle Imports

2. (U) Foreign automobile manufacturers in the Philippines complain that they were enticed to invest here with assurances of market protections, such as a general prohibition on entry of second-hand vehicles. However, vehicle importers in the Subic Freeport (a former U.S. naval facility) challenged this restriction, arguing that the freeport is not part of the Philippine customs territory under the Bases Conversion Development Act (Republic Act 7227) and that second-hand automobiles could legally be brought into Subic and sold in the domestic market, provided appropriate taxes and duties are paid.

3. (U) Philippine lower courts ruled in favor of Subic's used-vehicle importers. The Supreme Court subsequently ruled in February 2006 that second-hand vehicles could be imported into Subic but that it would be illegal to move them out of the freeport. The Supreme Court upheld its decision in August 2006 in response to a motion for reconsideration. The Department of Finance instructed the Bureau of Customs to issue a Customs Memorandum Circular to implement the Supreme Court decision since court procedures do not allow a second reconsideration. However, the vehicle importers then filed a "motion for clarificatory ruling."

4. (SBU) According to officials from the Car Manufacturers Association of the Philippines (CAMPI), this latest motion merely repeats the used-vehicle importers' arguments. However, because the Supreme Court allowed the parties to comment on the motion, the Customs Bureau has delayed implementing the earlier Supreme Court ruling on the matter.

Converted Vehicles Illegally Sold in Domestic Market

15. (U) Car manufacturers also stressed that most used vehicles enter the Subic Freeport with right-hand drive (mostly from Japan), then are converted to left-hand drive and auctioned. Republic Act 8506, issued in February 1998, prohibits the importation of right-hand automobiles, mainly for safety reasons. However, a 1999 Department of Justice (DOJ) opinion declared that it was legal to import right-hand drive vehicles into the country's freeports, provided that they are re-exported.

16. (SBU) The re-export requirement has been poorly enforced and many converted vehicles are illegally smuggled into Philippine customs territory. A 2005 Senate hearing estimated that only about 130 (0.1%) of about 90,000 right-hand drive vehicles that entered the Subic Freeport from 2001-2003 were re-exported.

17. (SBU) Car manufacturers here estimate that roughly 70% of foreign-origin used vehicles flow through Subic. The Port of Irene in the Cagayan Freeport Zone (about 600 kilometers north of Manila) is another major entry point of converted right-hand drives illegally sold in the Philippine market.

Vehicle Manufacturing Weakest in South East Asia

18. (SBU) Ford Motor Philippines officials told us that the illegal sale of converted, second-hand automobiles is their priority issue. They expressed alarm that the second-hand vehicle "gray market" has grown to about as large as the sum of local manufacturing and legally imported finished automobiles. They noted the large discrepancy between new vehicle registrations with the Land Transportation Office (174,108 units in 2006) versus legal sales

MANILA 00003387 002 OF 003

(99,541 units), attributing most of that difference to used-vehicle imports. The Ford officials estimated that the Philippine vehicle manufacturing industry is operating at only 30% capacity.

19. (U) Other industry sources noted that in 2006, vehicle production in the Philippines was less than 10% of Thailand's, and less than 15% of Indonesia and Malaysia's production volumes. They noted that these countries have been more effective in implementing restrictions on second-hand vehicle imports.

Fuel Smuggling: Another Serious Concern

110. (U) Chevron Philippines executives noted that Republic Act 8479 (the Downstream Oil Industry Deregulation Act) opened the downstream oil industry to greater competition in the mid-1990s. The law attracted investments from both foreign and local companies in oil refining, fuel storage, distribution infrastructure, transport and marketing. However, smuggling of refined oil products creates unfair competition for legitimate refiners and importers. Although the Subic Freeport is the focal point of smuggling, the problem also exists in a number of other ports in the country.

111. (SBU) The Chevron executives observed that Subic imports far more fuel than it consumes. Much of the fuel is improperly declared in terms of volume, value, and/or fuel type to avoid the appropriate duties, value-added and/or excise taxes, and then enters Philippine customs territory. Fuel also leaves the Subic Freeport for other tax-free export zones managed by the Government's Philippine Economic Zone Authority, but the products are diverted to retailers instead.

Fuel Statistics Reveal Smuggling

112. (U) Citing data from the Philippine government's Land Transportation Office, Chevron officials told us that vehicle registrations over the last ten years increased by nearly 7% annually; on the other hand, gasoline demand expanded by only 0.6%

per year. They also said that oil fuel sales declined by an average 7.7% over the past two years according to Philippine Department of Energy data while the Philippine economy averaged 5.8% real Gross Domestic Product (GDP) growth.

Smuggling Robs the Government of Badly-Needed Revenues

¶13. (SBU) In addition to harming legitimate businesses, fuel and used-vehicle smuggling are robbing the government of badly-needed revenues. The car manufacturing industry estimates the Philippine government lost 5-10 billion pesos in taxes during 2006 on smuggled cars. The Petroleum Institute of the Philippines (an organization of downstream oil companies) estimates that fuel smuggling deprived the Philippine government of nearly 30 billion pesos in revenues last year. The combined revenue loss from used-vehicle and fuel smuggling equaled about 0.6% of Philippine GDP and more than 4% of tax collections. The Federation of Philippine Industries estimates that the Government could be losing well over 100 billion pesos annually from smuggling in general.

Still a Question of Political Will

¶14. (SBU) The joint foreign chambers in Manila and affected industry groups have intensified efforts in recent months to urge the Philippine government to enforce laws and regulations to curb the illegal sale of converted second-hand vehicles and smuggling of fuel products, especially through the Subic Freeport. It remains to be seen whether the newest anti-smuggling task force, headed by a new anti-smuggling czar, will yield better results. Despite frequent industry and business chamber representations with senior Philippine government officials, including President Gloria Macapagal-Arroyo, political will seems to be lacking. Lack of more rigorously-estimated business and revenue impacts makes it difficult to determine whether the situation has worsened or improved through the years. Nevertheless, legitimate businesses consider smuggling a major challenge and feel that anti-smuggling campaigns have not been pursued with vigor.

MANILA 00003387 003 OF 003

Comment

¶15. (SBU) The persistence of smuggling in the Philippines not only hurts legitimate businesses and cuts into much needed revenues for the Government, but also casts a cloud over the investment climate and calls into question the Government's sincerity to fight corruption. We will continue to work with the American Chamber of Commerce, other business and industry associations, and affected U.S. companies to keep government attention on the problem of second-hand vehicle and fuel smuggling and to advocate for a determined anti-smuggling campaign in the Subic Freeport. We are also exploring ways to use the U.S. technical assistance projects to keep pressure on for a more sincere and vigorous anti-smuggling drive. End Comment.

Jones